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# In the Supreme Court of the United States

OCTOBER TERM, 1941

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No. 319

BEAR GULCH WATER COMPANY, A CORPORATION, PETITIONER

*v.*

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 14–30) is reported in 40 B. T. A. 1281. The opinion of the Circuit Court of Appeals (R. 62–67) is reported in 116 F. (2d) 975.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 13, 1941 (R. 68). A petition for rehearing was denied May 1, 1941 (R. 69). The petition for a writ of certiorari was filed July 29,

1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTIONS PRESENTED

Petitioner is a corporation organized and operated for the purpose of selling water to private consumers for gain. Subsequent to its organization, its stock was acquired by the University of California by gift and purchase. Petitioner declared and paid no dividends in 1933 and declared and paid a dividend of $10,000 in 1934. The questions are:

1. Whether petitioner's income was exempt from federal taxation under section 116 (d) of the Revenue Acts of 1932 and 1934, respectively.

2. Whether the income of petitioner for 1933 and 1934 was exempt from federal income taxation on the ground that it was a corporation organized and operated exclusively for educational purposes within the meaning of Sections 103 (6) and 101 (6) of the Revenue Acts of 1932 and 1934, respectively.

## STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra,* pp. 13–15.

## STATEMENT

The facts, as stipulated (R. 39–43), presented in oral testimony (R. 43–52), and found by the Board of Tax Appeals (R. 15–19), may be summarized as follows:

Petitioner is a corporation organized under the laws of the State of California on October 8, 1889, for the purpose of erecting and operating a water distributing system (R. 15–16) as a business enterprise conducted for gain (R. 22). Petitioner was engaged during the years 1933–1934 and prior years in the business of distributing and selling water to private consumers in certain residential communities of California. It did not serve the University of California, which was located outside its area of distribution (R. 16, 20). Receipts from the sale of water to private consumers, from which it paid salaries and operating expenses, constituted the petitioner's sole source of income in 1933 and 1934 (R. 16–17). Petitioner employed a business manager and ten other employees (R. 16). It was in all respects a self-sustaining corporation, and was operated in the way a corporation is customarily operated (R. 19).

Prior to 1900, the University of California, a public trust, acquired by gift 80 percent of the capital stock of petitioner by gift, and prior to 1920 it acquired the remaining 20 percent by purchase. The petitioner's entire capital stock was owned by the University throughout 1933 and 1934 (R. 17, 41, 46–47). By the terms of the gift of 80 percent of the capital stock, all income derived by the University from that stock was to be used in maintaining the College of Commerce (R. 17). The University of California, by virtue of the Constitution of the State of California, is authorized to accept

and hold gifts in public trust through the medium of the Regents of the University of California, a private corporation organized and existing under the Constitution and statutes of the State of California (R. 17–18, 21–23).

During the years 1933 and 1934 all of the members of the Board of directors of petitioner were Regents of the University and also members of the finance committee of the Regents. Certain officers of petitioner were also officers of the Regents or the finance committee of the Regents. The petitioner's directors held their meetings at the same place and on the same date as the finance committee. (R. 18.)

Petitioner acquired lands subsequent to 1920, taking title in its own name. In 1932 petitioner paid $12,000 to the Regents for land. All property owned by petitioner was held in its own name (R. 18). The Regents of the University loaned funds to petitioner for the construction of improvements, taking notes which were later refinanced by the issuance of bonds. These bonds and all other evidences of indebtedness of petitioner were owned by the University during 1933 and 1934 (R. 17, 44).

The excess of petitioner's income over expenses at the end of each year was credited to surplus. During 1933 petitioner did not declare any dividends and no income was received by the University from petitioner (R. 18–19). In 1934, at the

instance of the Regents, petitioner redeemed $20,000 of its bonds. In the same year petitioner declared and paid a dividend of $10,000 on its capital stock (R. 19).

Rejecting the petitioner's contention that all of its income for the years 1933 and 1934 was exempt under Section 116 (d) of the Revenue Acts of 1932 and 1934, respectively, the Board held that petitioner was a corporate entity separate and distinct from its stockholders and was not an agency of the state (R. 22–24); that no income accrued to the state or any political subdivision thereof in 1933 by virtue of mere ownership of petitioner's stock by the University, and that therefore none of petitioner's income for 1933 was exempt from tax under Section 116 (d) of the Revenue Act of 1932 (R. 24–28); and the Board further held that while a dividend of $10,000 was paid to the University in 1934, petitioner was not thereby relieved from tax on this portion of its income, because Section 116 (d) merely contemplates a refund to the state or political subdivision, rather than exemption of the petitioner (R. 29–30). The Board therefore sustained the Commissioner's determination in all respects (R. 30).

The court below affirmed for substantially the reasons advanced by the Board. It rejected the new contention advanced by petitioner that its income was exempt under Sections 103 (6) and 101 (6) of the Revenue Act of 1932 and 1934, respec-

tively, because it was a corporation organized and operated exclusively for educational purposes (R. 62–67).

**ARGUMENT**

## I

The purpose of Section 116 (d) (Appendix, *infra*) as originally enacted, to exempt certain nontax revenues realized directly by State and local governments, is stated in the following excerpt from the report of the Senate Finance Committee, commenting upon Section II G (a) of the Tariff Act of 1913, 38 Stat. 114:

> Immediately following the foregoing amendment a further provision is inserted to meet the cases of States, cities, towns, and other political subdivisions *which are in receipt of income* from sources other than that of taxation and about which question was raised that such incomes might be held subject to the tax. One State enjoys a revenue from the gross earnings of a railway company to which a land grant was made by the State years ago. A city under its contracts with the street railway companies is entitled to a certain per-cent of the net earnings per annum. While it was regarded improbable under the provisions of the bill that these revenues to States and municipalities would be construed as taxable income, to foreclose all doubt the amendment is inserted expressly exempting such revenues from the operation of the act. (S. Rep. No. 80, 63d

Cong., 1st Sess., p. 26 (1939–1 Cum. Bull. (Part 2) 3, 4–5).) [Italics supplied.]

Petitioner's argument for exemption under Section 116 (d) relies solely upon the first paragraph of that section (Pet. 17).[1] Petitioner urges the first paragraph is meaningless unless it immunizes from taxation a public utility corporation 100 percent of whose stock is owned by a governmental unit (R. 15). But the paragraph is plainly applicable to a utility which is directly owned and operated by the government itself. The explanation of the Senate Committee, quoted above, removes any ground for supposing that the objective of exempting enterprises of that nature should be left to doubtful constitutional restrictions.

Assuming that any dividends actually received from the petitioner by the University of California would be exempt to the University as "income derived from any public utility * * * and accruing to any State * * * or any political subdivision," it does not follow that the profits of the utility are exempt to the utility as income "accruing to" the University. In the Senate report accompanying the revenue bill of 1928, Section 116 (d) was said to relate "to the taxability of

[1] Additional limited exemption was granted by Section 116 (d) to public utilities with which local governments had already contracted, to the extent that the income tax would impose a burden upon such governments. For reasons presently to be stated, however, the provision of Section 116 (d) now applicable affords no basis for exempting the petitioner.

such of the income from a public utility as may *accrue directly* to the benefit of any State * * *." S. Rep. No. 960, 70th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 409, 422). [Italics supplied.]

The petitioner's income did not accrue directly either to the State or the University of California during the taxable years. It was instead available to the petitioner for its ordinary business purposes. Both the Board and the court below found that petitioner was a corporate entity separate and distinct from its shareholders. In *Citizens' Water Co.* v. *Commissioner,* 32 B. T. A. 750, affirmed 87 F. (2d) 874 (C. C. A. 8), certiorari denied, 302 U. S. 694, the city was a stockholder of a utility company and under an ordinance defining the relationship between the city and the company, had the right to acquire all of the surplus earnings of the company. Neither of these factors was considered sufficient to exempt all or any part of the company's income. See also, *Philadelphia Rapid Transit Co.* v. *United States,* 8 F. Supp. 152 (E. D. Pa.).

The extended colloquy in the Senate, excerpts from which are quoted in the petition (pp. 18–21),[2] was prompted by the desire for assurance that the utilities would not themselves benefit from the exemption. In a portion of the colloquy following that quoted, Senator Shively said (p. 5321):

> The fact is that we were trying to draw the line sharply between the revenue derived by the corporation from its business

[2] Cong. Record, Vol. 50, Part 6, pp. 5320–5322.

> and the revenue derived by the Government from the corporation.

The limited purpose of the exemption is further demonstrated by the action of Congress in amending Section 116 (d) in the Revenue Act of 1924, in order to make more certain that the benefit of the exemption should extend only to the governmental unit and not to a private taxpayer. Section 213 (b) (7) of the Revenue Act of 1924 43 Stat. 253), and H. Rep. No. 179, 68th Cong., 1st Sess., p. 21 (1939–1 Cum. Bull. (Part 2) 241, 256), S. Rep. No. 398, 68th Cong., 1st Sess., p. 24 (1939–1 Cum. Bull. (Part 2) 266, 282), and H. Conference Rep. No. 844, 68th Cong., 1st Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 300, 302, 303). This amendment eliminated even the formal exemption previously accorded a utility with which the government had entered into a contract, providing instead for a refund to the government to the extent that payments to it were reduced by reason of the imposition of the tax upon the utility. The House report in connection with the amendment of the provision in 1924 said (H. Rep. No. 179, 68th Cong., 1st Sess., p. 21, *supra*):

> This section has been amended to make it clear that the benefit of the exemption therein provided for shall accrue only to the State or political subdivision thereof affected and not to any private taxpayer.[3]

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[3] While it may be conceded that the University entered into the requisite contract with petitioner by acquiring 80 per-

Petitioner contends (Pet. 13–14) that the decision below is in conflict with *Jamestown & Newport Ferry Co.* v. *Commissioner,* 41 F. (2d) 920 (C. C. A. 1). The rationale of that decision, however, is such that the result does not seem to rest upon the presence of a provision corresponding to Section 116 (d). The court's analysis of the status of the ferry company was, in effect, that it constituted an instrumentality of government, engaged in carrying on a governmental function. The ferry system was organized at the behest of the municipality and was operated for the benefit of the municipality and its inhabitants without profit either to itself or to the municipality. The resulting identity of the company and the government in that case is a conclusion that has been expressly rejected below in the case of the instant taxpayer.[4]

## II

Petitioner further contends (Pet. 11–13) that its income for 1933 and 1934 was exempt because it

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cent of its stock, it is sufficient to point out that this provision affirmatively directs payment of the tax by petitioner. S. Rep. No. 960, 70th Cong., 1st Sess., p. 19, quoted *supra*, is an additional clear legislative expression that whatever exexemption arises under Section 116 (d) is for the benefit of the governmental unit through recourse to the refund process. To the same effect is H. Conference Rep. No. 1882, 70th Cong., 1st Sess., pp. 15–16 (1939–1 Cum. Bul. (Part 2) 444, 448). Whether the University of California is a political subdivision of the State and as such entitled to a refund, is a question not involved in this proceeding.

[4] The decision in the *Jamestown* case was expressly limited (p. 923) "to the facts of this case."

was a corporation organized and operated exclusively for educational purposes, within the meaning of Section 103 (6) of the Revenue Act of 1932 (Appendix, *infra*), and Section 101 (6) of the Revenue Act of 1934 (Appendix, *infra*). This contention was raised for the first time in the court below and was there rejected (R. 64–65). The court pointed out that the Board of Tax Appeals had not found that petitioner was organized for any educational purpose, but rather for the purpose of operating a water distributing system as an ordinary business enterprise for the benefit of its private shareholders, and that its stock had been acquired by the Regents through gift and purchase subsequent to its organization. These findings the court held to be supported by substantial evidence and hence conclusive.

Petitioner urges (Pet. 11–12) a "direct conflict" between the decision of the court below and *Roche's Beach, Inc.* v. *Commissioner,* 96 F. (2d) 776 (C. C. A. 2). No conflict is apparent. In the *Roche's Beach* case the taxpayer was organized as well as operated exclusively for charitable purposes. The articles of incorporation of the taxpayer did not disclose that purpose and the court held that for the purpose of determining the applicability of the exemption the requisite purpose need not be found in the charter, but that extrinsic evidence might be adduced to show that the organization of the taxpayer was exclusively for

charitable purposes. The court's discussion of its earlier decision in *Sun-Herald Corporation* v. *Duggan*, 73 F. (2d) 298 (C. C. A. 2), establishes the absence of any conflict with the case at bar. The record herein contains no evidence of any kind that the petitioner was either directly organized for educational purposes, or that its net income was to be so applied. Indeed, the Board's express finding to the contrary is undisputed.

### CONCLUSION

The decision below is correct and there is no conflict. The petition should therefore be denied.

Respectfully submitted.

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AUGUST 1941.